

Internal Revenue Service
Director, Exempt Organizations

Department of
P.O. Box 2506
Cincinnati, OH

Date: MAY 24 2001

Employer Identification Number:
[REDACTED]

Person to Contact - I.D. Number:
[REDACTED]

Contact Telephone Numbers:

[REDACTED] Phone
[REDACTED] FAX

CERTIFIED MAIL

Dear Applicant:

We have considered your application for tax exempt status under Section 501(c)(3) of the Internal Revenue Code. Based on the information submitted, we have concluded that you do not qualify for exemption under that section.

The evidence presented disclosed that you were incorporated on [REDACTED] in the [REDACTED].

The purposes for which the corporation was formed are as follows:

"To operate educational organizations and for any other purpose permitted by [REDACTED] ([REDACTED])"

The information submitted in part II of your Form 1023 application indicates that your primary activity is to present formal instruction of a standard academic elementary curriculum to a regularly enrolled student body, by a full time faculty at [REDACTED], at [REDACTED].

In addition to the formal academic curriculum, the students will receive education in [REDACTED], [REDACTED], [REDACTED], [REDACTED], [REDACTED], and [REDACTED], taught by a regular part-time staff at [REDACTED].

Furthermore, the children will participate in a variety of community service programs in and around [REDACTED].

According to the information submitted in Schedule I of Form 1023 application, [REDACTED] is a successor to a for profit school named [REDACTED] that is still in existence. [REDACTED] operated as the elementary school from [REDACTED] to [REDACTED], which [REDACTED] assumed in [REDACTED] of [REDACTED]. [REDACTED] still maintains ownership of all school equipment and

office supplies it purchased and continues to purchase additional equipment as needed.

In [REDACTED], [REDACTED] created [REDACTED]. This [REDACTED] acquired the necessary loans to purchase five acres and build an elementary school in [REDACTED]. In [REDACTED], this organization acquired a construction loan to build an addition onto the existing school. [REDACTED] now holds [REDACTED] loans and leases the building and site to [REDACTED].

In [REDACTED], [REDACTED] and [REDACTED] created [REDACTED] and purchased the adjoining [REDACTED] acres to [REDACTED]. These [REDACTED] acres house the basketball court and the running track. [REDACTED] leases this property at a rate, which is significantly below market value.

[REDACTED] was created in [REDACTED] as a nonprofit organization, which took over the operation of [REDACTED] and now leases the school building from [REDACTED], the track and basketball court from [REDACTED] and the school materials and equipment from [REDACTED].

The commercial lease for the school building from [REDACTED] shows that [REDACTED] is the lessor. The organization has executed a lease in the amount of \$[REDACTED] annually from [REDACTED] until [REDACTED]. The commercial lease provides that maintenance and care of site including plate glass, electrical wiring, plumbing and heating installations become the sole responsibility of the lessee. The appraisal from [REDACTED] shows that the lease is at fair market value.

The lease agreement for the running track and basketball court from [REDACTED] shows that [REDACTED] is the lessor. The organization has executed a lease in the amount of \$[REDACTED] monthly from [REDACTED] until [REDACTED]. The appraisal from [REDACTED] shows that the lease is below fair market value.

The lease agreement for the school materials and equipment from [REDACTED] shows that [REDACTED] is the lessor. The organization has executed a lease in the amount of \$[REDACTED] monthly from [REDACTED] until [REDACTED]. The lease agreement indicates that the lessee shall maintain equipment and supplies in good working order and replace any damaged or lost lease items.

The promissory note dated [REDACTED] shows that [REDACTED] promises to pay \$[REDACTED] to the order of [REDACTED].

The officers of the for profit school, [REDACTED] are:

[REDACTED], [REDACTED]
[REDACTED]
[REDACTED]

The officers of the nonprofit school, [REDACTED] are:

[REDACTED], [REDACTED]
[REDACTED], [REDACTED]
[REDACTED], [REDACTED]

In [REDACTED], the initial board members of [REDACTED] appointed [REDACTED], [REDACTED] and [REDACTED] as its additional board members.

Also, [REDACTED] is employed as the lead teacher and principal of the school and receives \$[REDACTED] a year for her services in that capacity.

The organization's financial support will be primarily tuition, insurance and registration fees. And, fundraising activities may include special grants and endowments from private organizations.

Section 501(c)(3) of the Code provides, in part, for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, religious, scientific or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the

4

organization, or persons controlled, directly or indirectly, by such private interests.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court stated that the presence of-- even a single, non-exempt purpose, if more than insubstantial in nature, will defeat exemption under Section 501(c)(3) of the Code, regardless of the manner or importance of the truly exempt purposes.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that a gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's place, the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place. The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view.

Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994, indicates otherwise.

The Court concluded that KJ's fundraisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interests.

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for profit school converted to a nonprofit school. The former owners became the new school's directors. The former owner/new directors benefited financially from the conversion. The ruling concludes that private interests were served.

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3).

The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement is that an organization be operated exclusively for one or more exempt purposes. To determine whether this test is satisfied, section 1.501(c)(3)-1(c)(1) of the regulations directs the Service to determine if the organization engages primarily in activities which accomplish one or more exempt purposes. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes unless it serves a public rather than a private interest. Based on the facts that your organization has provided in the application for recognition of exemption, we are not able to conclude that you are operated exclusively for public rather than private purposes.

Similar to the organization described in situation #2 of Revenue Ruling 76-441, your organization serves the private interests of [REDACTED]. Even though the organization expanded its board, [REDACTED] remains firmly in control of its operations. She selected and served on the board of directors in addition to holding a salaried position. In this regard, the influence [REDACTED] maintains over your organization's operations is similar to the control exercised by the owners in KJ's Fund Raisers, Inc. v. Commissioner. It is notable that none of the assets previously owned or used by the school were transferred to your organization. The organization leases the school facilities and equipment from [REDACTED]. The appraisals show that all leases were at or below fair market value. However, the fact still remains that [REDACTED] and [REDACTED] still have control because they are contracting with themselves. Moreover, upon the dissolution of the organization, there would be no assets for distribution because [REDACTED] and [REDACTED] would own everything free and have used the organization to pay for them. This is substantial private benefit to [REDACTED] and [REDACTED].

Accordingly, we conclude that you do not meet the requirements for exempt status under section 501(c)(3) of the Code and propose to deny your request for exemption under that section.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1120 or 1041.

Contributions made to you are not deductible by the donors as charitable contributions as defined in section 170(c) of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

You have the right to protest this proposed determination if you believe it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organization Appeal Procedures for Unagreed Issues." The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that:

A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within the time specified, this will become our final determination. In that event, appropriate State officials will be notified of this action in accordance with the provisions of section 6104(c) of the Code.

Sincerely,

Steven T. Miller

Steven T. Miller
Director, Exempt Organizations

Enclosures: Form 6018
Publication 892